

Thus far--and in large part thanks to the miracle of major seasonal and definitional revisions in the money supply--money growth, measured by narrow definitions, appears on track with the target for December to March set by the Committee at its last meeting. But such a course now looks as if it will be associated with less ease in credit conditions than might have been expected at that time. Money demands are likely to be stronger in reflection of a revised and less weak staff GNP projection for the first quarter. As a result, should that projection be accurate, the quite moderate increase in money supply targeted by the Committee may entail little, if any, decline in the Federal funds rate over the weeks immediately ahead. But, with economic activity projected to be weaker in the second quarter, some further decline in the funds rate is more likely to occur in early spring, particularly if the Committee were to encourage a bit more rapid expansion in M-1A or M-1B in the second quarter than in the first, as suggested by alternative B.

But there may also be some question about whether it will in fact be possible to keep money growth to modest proportions over the coming months without exerting upward pressure on the funds rate. Such upward pressure would be most likely to arise, of course, if the economy strengthens relative to the staff forecast. In that case upward rate pressure would appear consistent with the cyclical situation.

On the other hand, there are two possible developments that could tend to lead to the seeming anomaly of upward short-term interest rate pressures in a weakening economy, given money growth over the next few months

along the alternative B path. One would be emergence of greater demand for money relative to income than the staff is projecting. We have assumed that money demand will be weak enough to permit a bit stronger behavior in velocity of M-1A and M-1B over this and the next quarter than has usually been the case in post-war cyclical peak-to-trough periods. In the present inflationary environment the public in fact may be content to let the real value of cash balances decline sharply and attempt to maintain the real value of wealth--to the extent they can--by, say, acquiring other physical and financial assets that are more hedged against price rises. But if the public should turn out not to be willing to let cash balances decline relative to income, interest rates would come under upward pressure and/or nominal GNP under downward pressure as the public adjusts to the constrained supply of money.

The second development that could generate upward rate pressures over the next few months has somewhat greater odds of occurring. This would be the impact on money growth of the considerable bulge, relative to earlier years, in individual income tax refunds that is expected to begin sometime in late winter. While we are reasonably confident about our estimate of the amount of these refunds, we are quite uncertain about the exact timing--which depends on the speed with which the public files tax forms and the speed with which the IRS processes them. We are also uncertain about the exact response of the public to refunds received--whether placed initially in demand accounts or immediately in other assets, and if in demand accounts, whether they stay only one day or more. As noted in the bluebook, we would expect any upward impact of the refunds on money to be temporary--that is, it would not reflect a more permanent shift in money demand but would be followed in late spring and early summer by a tendency for money to grow slower.

Because of all the uncertainties involved no advance special allowance was made in the proposed monetary targets for the impact of tax refunds. Therefore, if the refunds do in fact tend to raise growth in the monetary aggregates beyond the proposed targets, short-term interest rates would temporarily come under upward pressure--a pressure that would be reversed later in the spring and summer as the flow were in effect reversed. However, the Committee may not wish to see interest rates rising over the months ahead for such a reason, especially if in fact the economy is weakening.

So far as I can see there is no easy practical solution to the dilemma posed by tax refunds. Deciding to adjust reserve paths to permit more money growth to the extent such growth can be identified as related to tax rebates has an appeal, but it is difficult to be certain that a higher money growth in any month is in fact temporary and related to the rebates. We have had experience in the past under a funds rate target--a target that makes it easy to accommodate to temporary bulges in money growth--where the bulge in growth has not been reversed, or fully reversed, and money over time ran higher than desired. Moreover, in deciding on whether to make any special allowance the Committee would probably also want to take account of the public impact of upward adjustments in targets--even by no more than the 1 or 2 percentage points that we now estimate to be the special effect of tax refunds--at a time when many in the market have been questioning the resolve of policy, though doing so for misguided reasons.

One approach would be to ignore the question on the ground that impacts on money now seem relatively minor, or it might be ignored on the ground that the risk of permitting higher growth in money can't be taken in the present environment. On the other hand, if the Committee wished to allow for some temporary increase in money growth, it might do so by recognizing--either in the directive or in the policy record--the possibility that money growth might deviate temporarily from target in case of unusually large individual income tax refunds.

If the Committee desired to make such an allowance, there are a number of ways to do so. One way would be to indicate that the Manager need not lower the nonborrowed reserve path over the next few months if total reserves are running persistently strong. In that case, interest rates would probably rise as borrowing rose but not by as much as if nonborrowed reserves were lowered. A much more accommodative approach would be to raise the nonborrowed reserve path to the extent that any bulge in money appeared to reflect the rebates, as determined by, say, analysis of the actual bulge in money compared with the actual timing of rebates. But such an interpretation leaves the staff with a very difficult and ticklish analytic problem. A third less rigid interpretation would be to permit the Manager to be tolerant of a little more money growth than formally targeted should that emerge, and there was reason to think it was related to refunds, without straining for precision in hitting total and nonborrowed reserves targets.

A final, brief word Mr. Chairman on another practical problem--the problem of which of the proposed aggregates should be given most weight in adjustments, if any, to the reserve path. On that issue, at present, I would suggest roughly equal weight to M-1A and M-1B, so as to minimize the risk that we are not overlooking significant growth in transactions balances. In any event, as a practical matter, M-1A and M-1B ought

to move closely together under current circumstances. I would suggest giving M-2 a more subsidiary role until we have more experience with it and with assessing the significance for policy of changing behavior of money market funds and overnight RP's relative to uncertain staff projections.